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Research:

Bonneville Power Administration Faces Declining Cash Flow

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Standard & Poor's maintains a stable outlook on Bonneville Power Administration (AA-/Stable/--) despite a second year of declining cash flow. The stable outlook reflects reduced risk at Bonneville for managing water risk on behalf of customers, improved rate flexibility, and an expected return to a positive cash flow situation in fiscal 2003, with a replenishment of cash reserves anticipated over the next few years. The declining cash flow in 2002 results from the unexpected drop in western market power prices experienced in 2002.

Bonneville is one of four regional federal power-marketing agencies in the U.S. Department of Energy and is subject to its authority and that of the executive branch of the federal government. Bonneville acts as the federal marketing agent for all of the federally owned hydroelectric projects in the Pacific Northwest. It also markets the power from five nonfederally owned hydroelectric projects, as well as for the Columbia Generating Station, a 1,250 MW nuclear plant near Richland, Wash. Wholesale rates must be approved by the FERC, which must ensure that Bonneville recover its costs and amounts sufficient to assure repayment of about \$2.5 billion of federal Treasury debt (interest-bearing debt issued by the federal government and repaid by Bonneville).

Power is sold to more than 100 publicly owned and cooperatively owned utilities (preference customers) for resale to retail consumers in Washington, Oregon, Idaho, and western Montana. Bonneville also sells to investor-owned utilities and directly to certain industrial customers.

The low water conditions that most utilities in the Northwest faced in the 2001 water year also took a toll on Bonneville. Bonneville had long-term, fixed-price contracts at between \$20 and \$25 per megawatt-hour (MWh) with its customers that expired at the end of the 2001 water year (Sept. 30). Although contract allocations were based on critical water level (the lowest water level on record), Bonneville was still purchasing power in the market during certain times to meet contracted demand at market prices that had skyrocketed to \$600 to \$700 per MWh due to high natural gas prices, California's failed deregulation attempt, and low water conditions. The revenues that Bonneville recovered from the fixed-price contracts were clearly insufficient to cover costs. As a result, Bonneville's cash reserves were reduced to \$667 million as of Sept. 30, 2001, from \$848 million in 2000. The fact that the loss was kept under \$200 million resulted from federal allowances for fish credits of about \$600 million against payments owed to the U.S. Treasury, up from \$60 million in fiscal 2000, to cover the market value associated with water spilled to protect fish. The unusually high amount of fish credits was directly related to exceptionally high power market prices and the corresponding market value of the foregone energy in water sent over the dams instead of through the turbines. Although Bonneville spilled less water in 2001 because of the power emergency, the value of the water that was spilled was much higher.

Bonneville signed new contracts with its preference customers that will be effective from Oct. 1, 2002 to Sept. 30, 2006. The demand on Bonneville for this five-year period is substantially higher (11,000 MW) than Bonneville's allocated resources (8,000 MW). Bonneville closed the 3,000 MW gap by signing longer-term contracts for about 1,000 MW and reached load-buyback and load-reduction agreements with customers for the remaining amount. A significant change in the revised preference contracts is Bonneville's ability to adjust rates for purchased-power costs every six months. This is a radical departure from the previous contracts. The rate adjustments are triggered only when necessary rather than for the purpose of collecting substantial reserves against price volatility in advance. This contractual change resulted in a 46% rate increase to customers on Oct. 1, 2001, also known as the load-based cost-recovery adjustment clause (CRAC). The load-based CRAC reduced slightly to 42% on April 1, 2002, as a result of some of the above-market load-buyback contracts expiring.

If rates have been increased to cover higher purchased-power costs, why is Bonneville still expecting negative cash flow in fiscal 2002? Bonneville is recovering the "augmentation" costs from customers.

However, revenues are lower than projected due to very low market power prices. Bonneville continues to sell into the market during various times of the year (spring and summer) and during particular hours of the day. Prices are about one-half of what Bonneville projected when it set its 2002 budget, and rates, last year. The result is the anticipated triggering of another rate adjustment in October 2002, known as the financial-based CRAC. This CRAC triggers when net revenues drop below a certain level and is intended to replenish cash reserves. Lower market prices account for roughly 75% of the \$460 million cash flow reduction that Bonneville projects by the end of fiscal 2002. The other 25% is expected as a result of below-normal water conditions. Although much improved from last year, the 2002 water year run-off is currently below average. If this remains the case, this could result in a loss of revenues below what was projected in the budget based on normal water conditions.

Bonneville has expressed its intent to recover this \$460 million loss over the next four years. Standard & Poor's expects the administration to return to a positive cash flow position in fiscal 2003, replenishing cash reserves from the expected low point of about \$225 million at the end of fiscal 2002. The credit outlook remains stable due to the CRAC mechanisms available to the administration to recover expenses as well as a commitment to reduce operating expenses to levels anticipated in the original rate case.